In a brochure put out by petitioner, the water system is described as follows:

In order to provide fire protection and to supply home owners in The Colony, with pure, soft water, The Colony will have its own private water works. The chief source is a well which is now producing 576,000 gallons of pure water each twenty-four hours, sufficient for the normal use of 14,000 people. Water will be supplied to home owners from a 75,000-gallon concrete reservoir. The water supply will at all times be under the supervision of the State and County Boards of Health.

The water system constructed by the petitioner was intended to supply 20 houses to be located near The Colony, as well as the houses located in The Colony subdivision. Also, during the taxable year ended October 31, 1948, the petitioner sold an additional 40 acres of land from the original farm tract. The 40 acres were sold at public auction, and in order to induce purchasers to pay a higher price, the petitioner agreed to provide water for the land.

The total cost incurred by petitioner in constructing the water supply system was $33,781.70, as follows:

Pumping system	$16,528.12
Distribution system	13,885.31
Engineering fees	2,864.18
Unclassified	504.09
Total	$33,781.70

The petitioner retained easements over lots which it sold in The Colony. These easements reserved to petitioner the right to maintain its water distribution system on the lots, but did not obligate petitioner to do so.

The water supply system began operation sometime during the taxable year ended October 31, 1949. Water meters installed by petitioner measured the water supplied to the houses served by the water distribution system, and petitioner was paid by the consumers for the

water it provided. In the taxable years ended October 31, 1949, to October 31, 1954, inclusive, petitioner realized, from the operation of its water supply system, the following amounts of gross receipts and profit or loss, the profit or loss being computed without deductions for electricity expense or depreciation:

Year ended October 31	Gross receipts	Net profit (or loss) before deduction for electricity or depreciation
1949	$211.89	($249.71)
1950	583.12	155.99
1951	258.08	(182.12)
1952	350.38	(382.39)
1953	421.37	(260.61)
1954	408.59	(183.96)

The largest item of expense incurred by the petitioner in the operation of the water system was for wages. L. J. Blakely, who lived near the pump site, was paid $300 per year to "look after" the water system in the years ending October 31, 1949, 1950, and 1951; $440 in the year ended October 31, 1952; $480 in the year ended October 31, 1953; and $400 in the year ended October 31, 1954.

The number of houses to which petitioner supplied water in each of the years set forth above is not shown in the record before us.

Throughout the taxable years and thereafter, the petitioner retained full ownership and control of the assets comprising the water supply system.

In 1948 and 1949, petitioner made payments to the Kentucky Utilities Company (hereinafter called Utilities Company) and the Central Kentucky Natural Gas Company (hereinafter called Gas Company), pursuant to agreements between petitioner and the companies relating to the

extension of gas and electricity service to The Colony. Petitioner's contract with the Gas Company was dated October 16, 1946. Petitioner entered into two contracts with the Utilities Company, one dated December 17, 1947, and the other dated December 1, 1949. The total payments made by petitioner to the two companies under the contracts amounted to $8,713.54, as follows:

Payee	Date of payment	Amount of payment
Gas Co.	January 6, 1948	$6,535.00
Utilities Co.	March 19, 1948	1,427.93
Utilities Co.	December 17, 1949	750.61
Total		$8,713.54

The payments made by petitioner were required by the companies before the latter would extend their services to The Colony. The contracts between petitioner and the companies provided that all or a part of the payments might be refunded to petitioner. For example, the contract with the Gas Company provided that the latter would refund to petitioner a total of $75 for each new customer connected to the company's gas mains, but that no refund would be made after 10 years from date of the contract, that is, after October 16, 1956. Each of the contracts with the Utilities Company provided for the refund of approximately $160 to petitioner for each new customer connected to the company's electric line, but that no refund would be made after 5 years from the time of completion of the service extensions provided for in the contracts. Exhibits 16 and 17 are incorporated by this reference. Up to the date of the hearing of this proceeding, the petitioner had received refunds of $1,407.41 from the Utilities Company and $750 from the Gas Company, or a total of $2,157.41, as follows:

Date of refund	Refunds from Utilities Co.	Refunds from Gas Co.
Nov. 9, 1948	$ 162.27	$150
May 23, 1949	162.27	....
May 28, 1949	.....	150
1951	491.49	450
1954	591.38	....
Totals	$1,407.41	$750

An account titled "Reserve for Improvements" was set up on petitioner's books and credited on September 30, 1946, in the amount of $93,074.61. This amount represented petitioner's estimate of the costs which would be incurred in the development of The Colony, and petitioner added a pro rata portion of this amount to its cost of each of the lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950.

The reserve account was debited in the amount of each expenditure which petitioner considered an expense of development for the subdivision. As of September 30, 1950 the total amount debited to the reserve account was $87,483.79, and on that date there remained, from the original credit entry of $93,074.61, a credit balance of $5,590.82. The total amount debited to the reserve account, $87,483.79, consisted of the following entries: $33,781.70, the cost of the water supply system; $8,713.54, the total of the payments made to the utility companies; and $44,988.55 for other expenditures which are not in issue.

For the purpose of computing gain from the sale of the lots which were sold in 1946, 1947, and 1950, the petitioner added a proportionate part of $93,074.61, the amount originally credited to the reserve account for improvements to its cost of the lots sold. In its returns for the year ending October 31, 1946, 1947, and 1950, petitioner reported gain from the sale of lots and gross income, as follows:

	Year ended October 31		
	1946	1947	1950
Selling price of lots	$78,987.50	$28,075.00	$8,000.00
Less cost of lots sold	57,375.00	18,575.00	7,500.00
Gross profit on sale of lots	$21,612.50	$9,500.00	$500.00
Other income	637.53	8,595.41	8,909.25
Gross income reported	$22,250.03	$18,095.41	$9,409.25

The respondent determined that the development costs which might be added to petitioner's cost of the lots did not exceed $44,988.55. Accordingly, the respondent determined that petitioner had overstated its cost of the lots in the total amount of $48,086.06, which is the difference between the estimated development costs claimed by petitioner, $93,074.61, and $44,988.55, the amount determined by respondent. The respondent also determined that petitioner overstated the costs of lots sold and understated the profit from lot sales in the years ended October 31, 1946, 1947, and 1950, in the amounts of $20,972.54, $6,789.80, and $2,741.51, respectively. The amount of the adjustment in each of these years is the portion of the total overstatement of cost determined by respondent, $48,086.06, which is allocable to the lots sold in each year. The method used by respondent to redetermine petitioner's cost of the lots sold in each year is as follows: The petitioner claimed a basis of $131,550 in the entire subdivision, after adding in the amount of $93,074.61 for the estimated cost of improvements. The respondent determined that petitioner overstated its basis in the amount of $48,086.06, and that the petitioner's basis did not exceed $83,463.94. The basis determined by respondent, $83,463.94, amounted to 63.44655 per cent of the basis reported by petitioner. Accordingly, respondent allowed petitioner, as the cost of the lots it sold each year, an amount equal to 63.44655 per cent of the cost claimed by petitioner in its returns.

The deficiency notice contains the following explanation for respondent's determination that petitioner realized additional income in the amount of $20,972.54 from the sale of lots in the year ended October 31, 1946:

It is held that the cost of lots sold in the fiscal year ended October 31, 1946, reported in the return filed for that year as amounting to $57,375.00, is not in excess of the amount of $36,402.46, the reduction representing the allocable portion of the following items incorrectly included in the computation of the total cost of the lots in the subdivision (Sections 24(a) (2) and 43 of the Internal Revenue Code):

(a) Cost of water system	$33,781.70
(b) Deposits with utility companies	8,713.54
(c) Excessive provision, reserve for improvements	5,590.82
	$48,086.06

Similar explanations appear for the adjustments determined by respondent for the years ended October 31, 1947, and October 31, 1950.

The total amount of development costs includible in petitioner's basis in the subdivision lots is $53,702.09. This amount is the total of the development expenses incurred by petitioner which are not in issue $44,988.55, and the total of the payments made by petitioner to the utility companies, $8,713.54. The estimated development costs claimed by petitioner, $93,074.61, were overstated in the total amount of $39,372.52. The basis in the subdivision lots claimed by petitioner, $131,550, also was overstated in the total amount of $39,372.52. Petitioner's basis in the subdivision lots did not exceed $92,177.48, or 70.07 per cent of the basis it claimed.

Petitioner's basis for gain in the lots it sold in the years ended October 31, 1946, 1947, and 1950, did not exceed

70.07 per cent of the basis claimed in its returns for each of these years. Petitioner's basis in the lots sold in these 3 years was $40,202.66, $13,015.50, and $5,255.25, respectively, computed as follows:

Year ended October 31	Basis per return	70.07 per cent of basis reported in return
1946	$57,375	$40,202.66
1947	18,575	13,015.50
1950	7,500	5,255.25

Issue 3. Statute of Limitations.

In the taxable years ended October 31, 1946, and October 31, 1947, petitioner's gross income amounted to $39,422.37 and $23,654.91, respectively, computed as follows:

	Year ended October 31 1946	1947
Selling price of lots (per return)	$78,187.50	$28,075.00
Basis in lots	40,202.66	13,015.50
Profit from sale of lots	$38,784.84	$15,059.50
Other income (per return)	637.53	8,595.41
Total	$39,422.37	$23,654.91

In each of the years ended October 31, 1946, and October 31, 1947, petitioner omitted from gross income an amount properly includible therein which was in excess of 25 per cent of the amount of gross income stated in its returns. The following schedule sets forth, for the years ended October 31, 1946, and October 31, 1947, the amount of petitioner's gross income; the amount of gross income reported by petitioner; the amount of gross income omitted from petitioner's returns; and the percentage which the gross income omitted bears to the gross income reported:

	Year ended October 31	
	1946	1947
Gross income	$39,427.37	$23,654.91
Gross income reported	22,250.03	18,095.41
Gross income omitted	$17,172.34	$5,559.50
Gross income omitted as percentage of gross income reported	77.2 per cent	30.7 per cent

Petitioner's income and declared value excess-profits tax return for the taxable year ended October 31, 1946, was filed on January 15, 1947. More than 3 years and less than 5 years later, on October 17, 1951, petitioner executed an agreement under the provisions of section 276 (b) of the 1939 Code extending the period of limitations for the assessment and collectoin of deficiencies for the year ended October 31, 1946, to June 30, 1952. On May 14, 1952, petitioner executed a second agreement extending the period to June 30, 1953; and on April 25, 1953, petitioner executed a third agreement extending the period to June 30, 1954.

Petitioner's return for the taxable year ended October 31, 1947, was filed on December 22, 1947. More than 3 years and less than 5 years later, on May 14, 1952, petitoiner executed an agreement under the provisions of section 276 (b) of the Code extending the period of limitation to June 30, 1953. On April 25, 1953, petitioner executed a second agreement extending the period to June 30, 1954.

The respondent's statutory notice of deficiency for the years ended October 31, 1946, and October 31, 1947, was mailed on March 29, 1954.

OPINION.

Issue 1.

HARRON, *Judge:*

The first question to be decided is whether the payments made by petitioner to five of its stockholders in the amounts of $8,988.41, $3,468, and $3,468, in the taxable years ended October 31, 1948, 1949, and 1950, respectively, were payments of interest on indebtedness, which are deductible under section 23 (b) of the 1939 Code, or whether the payments constituted nondeductible distributions in the nature of dividends. The determination of this issue depends on whether the $57,800 paid by the shareholders to petitioner in return for petitioner's notes constituted, in substance, a loan giving rise to a creditor-debtor relationship, or a contribution to capital, which gave the stockholders an additional proprietary interest.

The petitioner concedes that it is a "thin corporation." It argues, however, that the notes must be recognized as a valid indebtedness because the petitioner's capitalization reflected the business judgment of unrelated persons who dealt with each other at arm's length; because the notes were issued to the stockholders in face amounts which were disproportionate to their stock holdings; and because the transaction was carried out in the form proper to create an indebtedness, rather than a contribution to capital. The respondent takes the position that the $57,800 paid in by the shareholders must be considered as a contribution on their part to petitioner's capital, in view of the capital structure of the petitioner, the circumstances under which the notes were issued, and the lack of evidence indicating that the transaction was intended to create a debtor-creditor relationship.

The question to be decided is one of fact. Sam Schnitzer, 13 T. C. 43, 60, affd. 183 F. 2d 70, certiorari denied 340 U. S. 911. The issue is whether there was an intention to create a debtor-creditor relationship, on the one hand, or a capital contribution, on the other hand, "and such intention is a fact to be gleaned from the entire record." Estate of Herbert B. Miller, 24 T. C. 923. It is true, in this case, that the notes received by the five shareholders upon their payment of $57,800 to petitioner satisfy the formal requirements for a corporate indebtedness. However, our inquiry is not limited to the formalities, however meticulously observed, in which the parties cast their transaction. R. M. Gunn, 25 T. C. —— (Dec. 9, 1955); Estate of Herbert B. Miller, supra; Gooding Amusement Co., 23 T. C. 408, 418; Proctor Shop, Inc., 30 B. T. A. 721, affd. 82 F. 2d 792. There are other factors present which establish that the $57,800 was paid over to petitioner by the stockholders to be placed immediately at the risk of petitioner's business as a capital contribution rather than as a true loan.

In the first place, the petitioner's formal capital, $1,000 was patently inadequate to carry on the business for which it was formed. The petitioner was organized to purchase, subdivide, and sell a substantial tract of land. For this purpose, petitioner's formal capital of $1,000 was wholly insignificant. To finance the project the additional amount of $57,800 was turned over to petitioner by the stockholders, and in addition the petitioner obtained loans of at least $149,403 from banks. The bank loans were secured by liens on petitioner's real estate. The notes received by the stockholders were not secured. If petitioner's characterization of the transaction is accepted, it is apparent that petitioner's business was placed in operation with loans in the amount of $207,203, and formal capital in the amount of $1,000. This alleged arrangement, which amounts to an indebtedness to capital ratio of greater than

207 to 1, clearly establishes that petitioner was undercapitalized and strongly suggests that the shareholders recognized that the $57,800 would be risked in petitioner's business as a capital contribution to the same extent as the formal capital of $1,000. See Hilbert L. Bair, 16 T. C. 90, affd. 199 F. 2d 589. In these circumstances, we think our language in Isidor Dobkin, 15 T. C. 31, 33, affd. 192 F. 2d 392, is particularly appropriate:

> When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business. Cohen v. Commissioner, 148 F. 2d 336; Joseph B. Thomas, 2 T. C. 193. The formal characterization as loans on the part of the controlling stockholders may be a relevant factor but it should not be permitted to obscure the true substance of the transaction. Sam Schnitzer, 13 T. C. 43, 60.

The conclusion that the parties did not regard the payment of the $57,800 to petitioner as a loan is also supported by their conduct subsequent to the issuance of the notes in April 1946. For example, the notes were not paid on the due date, namely, 5 years after issue, i. e., in April 1951. In fact, the evidence indicates that only one of the notes, that issued to L. B. Shouse, has been retired, and that the other notes were still outstanding at the time of the hearing of this proceeding. The stockholders other than Shouse held their notes as late as 1953, 2 years after the due date, and the evidence does not indicate that any attempt to enforce payment was ever made at any time after the due date. The parties treated their shares of stock and the notes as part of a single package whenever a transfer was made. For example, when petitioner acquired Shouse's note, it also acquired his stock. Similarly,

in the transaction in 1953, in which Sturgill and Central Rock Company acquired, in equal shares, the outstanding stock of petitioner held by Meriwether, Blakely, Leet, and Nunn, the notes held by the latter four persons also were acquired.

On the basis of the foregoing, it is concluded that the petitioner has failed to establish that the notes issued to its shareholders in the face amount of $57,800 represented a valid indebtedenss. It is held that the respondent properly disallowed the deductions claimed by petitioner for interest on indebtedness for the years ended October 31, 1948, 1949, and 1950, in the respective amounts of $8,988.41, $3,468, and $3,468.

In reaching our conclusion we have considered petitioner's contentions concerning the disproportionate holdings among the shareholders of stock and notes. Under the circumstances of this case, we attribute to this no greater weight than if petitioner had issued disproportionate amounts of common and preferred stock. Similarly, we consider of little weight petitioner's argument that the obligations represented by the notes were not subordinated to claims of other creditors. It is true that the notes, on their face, were not subordinate obligations. Under the facts of this case, however, little significance can be attached to this factor. For one thing, there was a lien on petitioner's principal asset, its real estate, in favor of the banks. This lien secured loans made by the banks to petitioner in the original amount of at least $149,403. In the second place, it appears that petitioner's liabilities in each of the taxable years were in negligible amounts, compared to the $57,800 in question. For example, petitioner's liabilities at the end of the taxable years October 31, 1946 to October 31, 1950, ranged from a low of $986.04 on October 31, 1949, to a high of $5,325.74 on October 31, 1946, and

averaged $2,470.29. On the entire record, it is concluded that the respondent must be sustained on this issue.

Issue 2.

The narrow question to be decided under this issue is the proper amount which petitioner may add to its cost of Colony lots for the cost of development work in The Colony subdivision. It is well established that where subdivision lots are sold before development work is completed, the seller may include in his cost of the lots an allocation of his estimated future expenditures for improvements to the subdivision. Country Club Estates, Inc., 22 T. C. 1283, 1293-1294; Cambria Development Co., 34 B. T. A. 1155.

The petitioner included in its cost of Colony subdivision lots a total of $93,074.12 for development expenses, and added a pro rata portion of this total to its cost of The Colony lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950. The respondent determined that the development expenses claimed by petitioner were excessive, and that the proper amount to be added to petitioner's cost of the lots did not exceed $44,988.55. The respondent accordingly reduced the cost or other basis which the petitioner claimed in the lots which were sold, and increased the profit reported by petitioner from the sale of these lots. The amount by which the respondent reduced the petitioner's cost or other basis in the lots in each of the years ended October 31, 1946, 1947, and 1950, equalled a pro rata part of $48,086.06, the total amount by which the respondent reduced the development costs claimed by petitioner. The petitioner does not contest the percentage method used by respondent to redetermine the cost of the lots, in the event it is determined that petitioner overstated its development costs. The petitioner does claim, however, that its development costs

were not overstated in the amount determined by the respondent.

The petitioner included in its cost of Colony subdivision lots a total of $93,074.12 for development expenses, and added a pro rata portion of this total to its cost of The Colony lots which it sold in the taxable years ended October 31, 1946, 1947, and 1950. The respondent determined that the development expenses claimed by petitioner were excessive, and that the proper amount to be added to petitioner's cost of the lots did not exceed $44,988.55. The respondent accordingly reduced the cost or other basis which the petitioner claimed in the lots which were sold, and increased the profit reported by petitioner from the sale of these lots. The amount by which the respondent reduced the petitioner's cost or other basis in the lots in each of the years ended October 31, 1946, 1947, and 1950, equalled a pro rata part of $48,086.06, the total amount by which the respondent reduced the development costs claimed by petitioner. The petitioner does not contest the percentage method used by respondent to redetermine the cost of the lots in the event it is determined that petitioner overstated its development costs. The petitioner does claim, however, that its development costs were not overstated in the amount determined by the respondent.

The amount of estimated development costs disallowed by respondent, $48,086.06, is the total of three items, namely, an expenditure of $33,781.70 to construct a water supply system; payments to utility companies in the amount of $8,713.54; and the sum of $5,590.82, which is the excess of the petitioner's estimated development costs of $93,074.61 over the total amount it claimed to have expended for development purposes as of September 30, 1950, namely, $87,483.79. The respondent, in effect, allowed as development costs the total amount petitioner claimed to have expended as of September 30, 1950, other than the

cost of the water supply system and the amounts paid to utility companies.

The respondent's position under this issue is that the expenditures incurred to acquire the water supply system and to make payments to the utility companies are not properly chargeable to development costs which can be added to the cost of the subdivision lots. In the case of the portion of the estimated costs which petitioner had not expended as of September 30, 1950, or $5,590.82, the respondent contends that no part of the $5,590.82 will be required for future improvements, and that petitioner's original estimate of $93,074.61 for future developments was excessive in the amount of $5,590.82. The three adjustments will be discussed separately.

Petitioner introduced no evidence at the hearing of this proceeding to establish that further development work was required at The Colony after September 30, 1950, or that any expenditures were in fact made after that date for purposes of development or improvement. We accordingly sustain respondent's determination that the petitioner's estimate for future development costs, $93,074.61, was excessive in the amount of $5,590.82, which is the portion of petitioner's estimate which had not been expended as of September 30, 1950. Butler-Fornari Realty Corporation, 37 B. T. A. 933.

The next item under this issue relates to the water supply system. The petitioner has abandoned its original contention that the entire cost of the water supply system is a development expense which can be allocated to its cost of the subdivision lots. It concedes now that the "distribution system" or piping which carried the water from the "pumping system" to the houses, is not a development expense. It now claims that only the cost of the pumping station or pumping system is a development cost which should be added to its cost of the lots. The

petitioner contends that the lots were unsalable without a water supply system, and that it was required to construct such a system because the cost of connecting the subdivision with the facilities of the Lexington Water Company was prohibitive. The petitioner contends further that when the facilities of the Lexington Water Company eventually extend to the subdivision, the pumping station will be of no further use and will have no value other than for salvage. The petitioner contends that under these facts, the cost of the pumping system must be added to its cost of the lots. The petitioner relies on Country Club Estates, Inc., supra. In that case, the taxpayer was in the business of selling subdivision lots. In order to induce people to purchase lots, the taxpayer conveyed a portion of its tract to a nonprofit organization for the purpose of having a country club constructed. It was held that the cost of the property transferred by the taxpayer should be regarded as part of its basis in the subdivision lots which it sold.

The difficulty with petitioner's contention is that, unlike the taxpayer in Country Club Estates, Inc., supra, the petitioner has not given up any property in order to sell its lots. For the funds it expended, the petitioner acquired a water supply system which it owned and operated during the taxable years and thereafter. It is true that the system has not been operated at a profit, due, perhaps, to the small number of houses which have been constructed at The Colony. And it also may be true, as petitioner contends, that the pumping station may be abandoned at some time in the future, when the facilities of the Lexington Water Company reach the subdivision. These circumstances, however, do not alter the fact that the petitioner retained full ownership and control of the water supply system during the taxable years, and that it did not part with the property for the benefit of the subdivision lots.

Because of his retention of ownership, Country Club Estates, Inc., supra, is distinguishable. The retention of ownership also distinguishes this proceeding from cases in which the subdivider is permitted to add to his cost of lots the cost of land which has been dedicated or donated for use as streets. See, Commissioner v. Laguna Land & Water Co., 118 F. 2d 112, modifying, on other grounds, a Memorandum Opinion of the Board of Tax Appeals. We think the facts in this proceeding more closely resemble Biscayne Bay Islands Co., 23 B. T. A. 731. In the latter case, the taxpayer subdivided for sale the waterfront portion of its property. The interior portion of its property was set aside, for a term of years only, and not irrevocably, for use as a public park. It was held that the taxpayer's cost of the waterfront lots did not include the cost of the interior park property because the taxpayer had not irrevocably parted with the interior property. We said (page 735):

> This area was not permanently and irrevocably dedicated to the public, but may later be sold by petitioner. The possibility of gain has only been postponed. It is unlike the area used for public streets, which is permanently beyond the possibility of sale and gain, the cost of which must be absorbed in the salable lots. See *Oak Woods Cemetery Association*, 6 B. T. A. 1003.

It is held that the cost of the water supply system may not be added to the cost of The Colony subdivision lots for the purposes of computing petitioner's gain on the sale of such lots.

There is an additional dispute between the parties which relates to the cost of the water supply system. The respondent determined that the total cost of the system which the petitioner had added to its cost of the lots was $33,781.70. The petitioner claims that the cost of the system was $33,277.61, or $504.09 less than the amount determined by

respondent. The question is one of fact and the petitioner has the burden of proving the respondent's determination erroneous. The cost of the water supply system was not separately stated in the books of account maintained by petitioner. Petitioner relies, in support of its contention, on an analysis of invoices made by the engineer who supervised the construction of the water supply system. However, the evidence indicates that the engineer did not have available all the invoices relating to the construction of the system. At one point the engineer testified that "practically all" the bills for materials and services came into his hands; elsewhere, he stated that the bills of which he had knowledge accounted for about 80 per cent of the cost of the project. In either event, the petitioner has not established that the engineer upon whose testimony it relies had knowledge of the total cost of the system. It is concluded that the petitioner has failed to establish that the cost of the water supply system was less than the amount determined by the respondent. It is held that the cost of the water supply system was $33,781.70, and that this amount is not includible in the cost of The Colony lots sold by petitioner.

The final question relating to the petitioner's cost of The Colony lots concerns the payments made by petitioner to the Gas Company and to the Utilities Company. The petitioner made payments to the companies in the total amount of $8,713.54, and included this amount in the cost of its Colony lots. The respondent takes the position that the petitioner is not entitled to add any part of the payments to the cost of the lots it sold during the taxable years, because there existed a possibility that all or a part of the payments might be refunded to petitioner at some time after the taxable years.

The evidence establishes that the companies required the payments to be made before they would extend their

services to Colony. The payments were made to the companies in accordance with written agrements, the pertinent provisions of which are stated in the findings. Pursuant to the contract with the Gas Company, the petitioner paid $6,535 to the Gas Company in January 1948. The contract provided that the petitioner would receive a refund of $75 for each new customer connected to the company's gas mains, but that no refund would be made after 10 years from the date of the contract, i. e., after October 16, 1956. In the case of the second company, the Utilities Company, the petitioner made payments in the total amount of $2,178.54 in 1948 and 1949. The contracts with the Utilities Company provided that a refund of approximately $160 would be paid to petitioner for each new customer connected to the company's electric line, but that no refund would be made after 5 years from the time of completion of the service extensions provided in the contract. The period during which petitioner was entitled to receive refunds from the Utilities Company did not expire during the taxable years.

It is true, therefore, as respondent contends, that there was no way to ascertain, during the taxable years, the total amount of refunds which petitioner might receive under its contracts with the two companies. We do not think, however, that this circumstance militates against the petitioner. The determinative factor is that the petitioner made unconditional payments to the two companies in order to obtain utility service for The Colony, and thereby to attract customers for The Colony lots. The payments were thus closely related to the sale of the lots, and petitioner's income from the sale of lots will be more clearly reflected if a pro rata portion of the payments in question are included in its basis for gain or loss in each lot which was sold. On the other hand, the receipt of refund pay-

ments from the utility companies is less closely related to the improvement of the lots for sale. The payment of a refund would be made only if a new customer was connected to the utility companies' service extensions, rather than at the time a lot was sold. Thus, if lots were sold to purchasers who, for some reason, did not proceed to construct residences, the petitioner would not receive refunds; or, if a purchaser acquired two or more lots, on which only one residence was constructed, the petitioner would receive only one refund, rather than a number of refund payments equal to the number of lots sold to the purchaser. Under these circumstances, it is concluded that the payments to the utility companies were directly related to the improvement of The Colony lots for sale, and that the petitioner correctly included these payments in computing its basis for gain or loss in the lots which it sold. The question of the taxability of the refunds which petitoiner may receive from the utility companies is not before us. It is noted, however, that the petitioner concedes, on brief, that such refunds would, if made, constitute taxable income. See Chevy Chase Land Co., 34 B. T. A. 150.

Issue 3.

The final question to be decided is whether the deficiencies determined for the taxable years ending October 31, 1946, and October 31, 1947, are barred by the statute of limitations. The deficiency notices for these 2 years were mailed within the extended period provided in waivers which the petitioner originally executed more than 3 years and less than 5 years after the returns were filed. The question is whether the 5-year statute of limitations con-

tained in section 275 (c) of the 1939 Code[1] is applicable in this proceeding. The petitioner omitted from gross income in each year an amount properly includible therein which was in excess of 25 per cent of the gross income reported. The petitioner contends, however, that section 275 (c) is inapplicable because the omission resulted from an overstatement of cost of goods sold, rather than from an omission of gross receipts. The petitioner relies on Uptegrove Lumber Co. v. Commissioner, 204 F. 2d 570, reversing a Memorandum Opinion of this Court; and on Deakman-Wells Co. v. Commissioner, 213 F. 2d 894, reversing 20 T. C. 610. Our holding in Estate of J. W. Gibbs, Sr., 21 T. C. 443, however, requires that this issue be decided in favor of the respondent. We have recently reviewed the decision in the Gibbs case in the light of the decisions in the Uptegrove Lumber Co. and Deakman-Wells Co. cases, and have decided to adhere to the rule in the Gibbs case. John E. Goodenow, 25 T. C. 1. On the basis of the Gibbs and Goodenow cases, it is held that the 5-year statute of limitations in section 275 (c) is applicable, and that the deficiencies determined for the years ending October 31, 1946, and October 31, 1947, are not barred by the statute of limitations.

Decision will be entered under Rule 50.

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[1] SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

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(c) OMISSION FROM GROSS INCOME.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.